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720673—46——1

In the Supreme Court of the United States

OCTOBER TERM, 1946

Nos. 590 and 591

F. A. GILLESPIE AND SONS COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 25–39) are not reported. The opinion of the circuit court of appeals (R. 299–307) is reported at 154 F. 2d 913.

JURISDICTION

The judgments of the circuit court of appeals were entered on March 12, 1946 (R. 307–308). A petition for rehearing (R. 309–311) was denied

on May 23, 1946 (R. 313). By an order dated August 8, 1946, the time for filing petition for certiorari was extended to October 15, 1946 (R. 315). The petition for writs of certiorari was filed on October 9, 1946. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether this Court should reconsider its decision in *Virginian Hotel Co.* v. *Helvering,* 319 U. S. 523, and whether that decision results in an unconstitutional tax in this case.

2. Whether, in determining gain from the sale of a partial interest in an oil and gas lease, a proportionate part of intangible drilling and development costs should be allocated to the retained interest in the property.

3. Whether, in making certain payments under annuity contracts, the taxpayer is entitled to a deduction for interest paid under Section 23 (b) of the Revenue Act of 1936 and the Internal Revenue Code.

4. Whether, on recomputation of the tax deficiencies, the Tax Court properly adjusted the depletion allowance for 1937 and 1939.

STATUTES AND REGULATIONS INVOLVED

The applicable provisions of the statutes and regulations involved are set forth in the Appendix, *infra,* pp. 17–20.

STATEMENT

The Tax Court found the following facts:

In 1937, the taxpayer, an Oklahoma corporation, owned one-half of a seven-eighths working interest in eleven oil and gas leases in Texas, known as the Placedo leases. The remaining one-half of the seven-eighths working interest was owned by the Superior Oil Corporation which had drilled all the wells, except the first well, and had conducted the actual operations. (R. 26.)

The taxpayer and the Superior Oil Corporation each paid one-half of the drilling and development costs (R. 26). The taxpayer's share of the development costs had been capitalized in the amount of $142,467.80 (R. 27). In acquiring its interest, the taxpayer had incurred no original cost, or if it did, the cost was nominal and had not been capitalized (R. 26).

On June 15, 1937, the taxpayer sold its interest in the Placedo leases and in the leasehold equipment to Superior Oil Corporation. It received a cash consideration of $200,000, and reserved one-eighth of the seven-eighths of the oil and gas to be produced from the leases until the sum of $275,000 should be paid. No reservation was made with respect to the equipment. (R. 26.) From the date of the sale through March, 1944, the taxpayer received a total of $111,190.19 from the retained oil payment (R. 27).

The Tax Court found that, as of the date of the sale, the fair market value of the interest retained by the taxpayer in the Placedo leases was at least $100,000 (R. 27).

In its income tax returns for 1935, 1936, and 1937, the taxpayer had taken depletion, which was computed on the percentage basis, in the total amount of $19,673.29 for the Placedo leases (R. 27). In the deficiency determination, the Commissioner found that depletion for 1937 in the amount of $5,717.12, instead of $4,126.80, as taken by the taxpayer, was allowable, thereby making the total depletion allowance $21,263.61 (R. 28). The taxpayer's interest in the leasehold equipment had cost it $120,403.46, and deductions for depreciation thereon were taken in 1935, 1936, and 1937 in the total amount of $10,278.74 (R. 27).

In its tax return for 1937, the taxpayer reported a loss of $37,181.64 on the sale of its interest in the Placedo leases and in the equipment. This computation took no account of the value of the reserved interest in the leases or of the prior amount of depletion allowed. In the deficiency determination, the Commissioner computed gain from the sale in the amount of $45,780.73, having given a value of $100,000 to the interest reserved by the taxpayer, and having taken into account depreciation and depletion previously allowed (R. 28.)

Before the Tax Court, the Commissioner conceded that the computation was erroneous insofar as it failed to permit full recovery of the depreciated cost of the equipment before ascertaining the amount of taxable gain realized (R. 29.)

In 1939, the taxpayer was the owner of a lease, known as the Shear lease, which had no original or independent cost. During 1939, the taxpayer sold the lease, with the leasehold equipment thereon, for $49,950 cash, and retained an interest in one-eighth of seven-eighths of the production therefrom until the additional amount of $100,000 should be received. Leasehold development costs to the time of the sale amounted to $26,937.98. Of that amount, $22,439.71 had been capitalized, and the balance of $4,498.27 had been omitted. Depletion deductions taken by the taxpayer, and allowed by the Commissioner, with respect to the lease amounted to $1,345.85. The cost of the leasehold equipment to the time of the sale was $9,665.92, and the depreciation claimed and allowed with respect thereto was $483.30. In its income tax return for 1939, the taxpayer reported a gain of $19,449.66 on the sale of the lease. (R. 33.)

In ascertaining a deficiency, the Commissioner determined that the gain on the sale was $34,151.83. In making that determination, he concluded that the depreciated cost of the leasehold equipment was $9,182.62, that the leasehold cost, inclu-

sive of development cost, was $26,937.98, and was to be reduced by depletion allowances in an amount of $1,345.86, which would make a total net cost of the lease and the leasehold equipment of $34,774.75. He further determined that the value of the payments of $100,000 to be made from the one-eighth of the seven-eighths interest retained by taxpayer was $60,000, and that the value of the interest sold was $49,950, or $109,950 as the total value. Since the value of the interest sold represented 45.43 percent of the total value, he allocated such percentage, or $15,798.17 of the total cost of $34,774.75, to the cost of the interest. The balance of such cost, as determined by him, or $18,976.58, he allocated to the interest retained. Subtracting from $49,950, the selling price of the interest sold, the amount of $15,798.17, the portion of the total cost allocated to such interest, the Commissioner arrived at the gain stated above. (R. 33–34.)

The parties have stipulated that at the time of the sale the fair market value of the interest retained by taxpayer in the lease was $5,000, instead of the value of $60,000, determined therefor by the Commissioner (R. 34).

Pursuant to a contract entered into on May 15, 1929, between taxpayer and F. A. Gillespie and Maud Gillespie, husband and wife, there was transferred to taxpayer the following properties, of the indicated values, which were owned jointly (R. 34):

U. S. Liberty Loan bonds and Port of New Orleans State bonds	$1,172,000.00
Empress Building, Tulsa, Oklahoma	150,000.00
Sundry lands and lots located in Oklahoma	22,512.00
Cash and accounts receivable	94,365.22
Sundry stocks	25,363.00
Total	1,464,240.22

The cost of these properties to F. A. Gillespie and Maud Gillespie equaled or exceeded the fair market value (R. 34–35).

Under the terms of the contract, the taxpayer agreed to pay F. A. Gillespie $15,000 per year, for life, and to pay Maud Gillespie $15,000 per year, for life, and, in addition, guaranteed to her that she should receive annually for life as dividends, an amount equal at least to $10,000, and that, if for any reason funds should not be available for the declaration of dividends in that amount, the taxpayer would pay such sum to her (R. 35).

F. A. Gillespie was born on August 22, 1868, and Maud Gillespie, on June 9, 1872. An annuity upon the life of a male individual born in the United States on August 22, 1868, which would have paid $15,000 per annum to him for his life, could have been purchased from a reputable life insurance company doing business in the United States on May 15, 1929, for the sum of $153,750. An annuity upon the life of a female individual born in the United States on June 9, 1872, which would have paid $15,000 per annum to her for her

life, could have been purchased from a reputable life insurance company doing business in the United States on May 15, 1929, for the sum of $196,537.50. (R. 35.)

Under the terms of the contract of May 15, 1929, the taxpayer paid F. A. Gillespie a total of $54,375 for the years 1929 through 1932, and for the years 1933 through 1942, the amount of $15,000 per annum. The taxpayer paid Maud Gillespie for 1932, and for certain settlements to that time, a total of $34,891.01. For 1933, she was paid $25,000, and in November of that year she agreed that the taxpayer might cease paying her the additional $10,000 per annum, guaranteed to her as dividends or otherwise to be paid to her by taxpayer. However, in 1934, she was paid $20,000. For the years 1935 through 1940, she was paid $15,000 per annum. She died during 1941, and for the portion of the year ending with September, she was paid $12,250. (R. 35.)

The Tax Court decided, in computing gain on the sale of the leases, that proper adjustment was required to be made for the prior deductions taken for depletion and depreciation, without regard to whether any tax benefit had been received. It also held that a proportionate portion of the capitalized intangible drilling and development costs must be allocated to the taxpayer's retained interest in the leases. (R. 30–33, 34.) It likewise ruled that the amount of depreciation for

1937 which had been claimed by the taxpayer and allowed by the Commissioner was not shown by the taxpayer to be excessive (R. 30–31). It also decided that, on recomputation, the amount of depletion allowed for 1937 and 1939 was required to be adjusted in accordance with its decisions in the present cases (R. 49–50, 286–287).

The Tax Court further held that no part of the payments made in 1937 and 1939 to F. A. Gillespie and to Maud Gillespie under the annuity contracts could be deducted as interest paid (R. 36–37). The circuit court of appeals affirmed the decisions of the Tax Court in all respects (R. 299–307).

ARGUMENT

1. In *Virginian Hotel Co.* v. *Helvering,* 319 U. S. 523, it was held that Section 113 (b) (1) (B) of the Internal Revenue Code requires that the basis for property be adjusted to reflect all prior deductions for depreciation which were claimed in the taxpayer's return and which were not disallowed by the Commissioner. It was decided that the adjustment must be made even though the amounts previously deducted by the taxpayer were excessive and did not alter the tax liability which would have obtained if only a proper amount of depreciation had been taken in the prior years. While the *Virginian Hotel* case involved the basis for determining depreciation in the taxable year and the present case involves

the basis for determining gain on a sale, it is apparent that the cases are not distinguishable since the statute makes the same adjusted basis the reference point for both purposes. See Sections 113 (b), 23 (n), and 114 (b) (1) of the Internal Revenue Code and of the Revenue Act of 1936, Appendix, *infra*, pp. 18–19. Accordingly, the courts below were correct in deciding that the adjusted basis in this case must be determined in accordance with the principle of the *Virginian Hotel* case.

The taxpayer, however, contends that the *Virginian Hotel* case was erroneously decided and that the decision ought to be reconsidered (Pet. 6–8, 9–10). It is also argued that the effect of following that decision where gain on a sale is involved is to tax part of the return of the taxpayer's capital and that such a tax is repugnant to the Sixteenth Amendment to the Constitution of the United States as not being a tax on income (Pet. 8, 10).

At the outset, we wish to emphasize our conclusion that the record in this case does not present the question which the taxpayer is seeking to have reviewed. That is, the taxpayer contends that no adjustment in the basis of the property should be or can be made as the result of prior deductions for depreciation which were excessive and which did not give any tax advantage. The record, however, contains no convinc-

ing proof that the depreciation deductions in this case were excessive.[1] The Tax Court found that the taxpayer had not proved that depreciation for 1937, one of the tax years in controversy, had been claimed in an excessive amount; on the contrary, it held that the taxpayer's own evidence and method of computation showed that the amount of depreciation allowed for that year was properly allowable (R. 30–31). While the Tax Court made no express finding concerning the other years, the matter being properly considered irrelevant (R. 30), the same conclusions would be required for those years since the same type of evidence applicable to 1937 was the only proof offered respecting the prior years. Furthermore, it is not altogether correct to assume that the taxpayer received no tax advantage from the depreciation deduction which was claimed and allowed, for, as was pointed out in the *Virginian Hotel* case, 319 U. S. at 527, note 8, where such a deduction is only one of several claimed, they all actually produce the loss shown in the return.

At all events, we believe that it is reasonable and proper for Congress to provide that where a taxpayer has claimed and been allowed deductions for depreciation in prior years, he should not be permitted to assert that the physical depreciation which occurred was different from that claimed in

[1] Unlike the *Virginian Hotel* case, *supra*, the Commissioner has made no such determination here.

his prior tax returns. Once having claimed and been allowed the deduction, the taxpayer should not be permitted to take it again under either the guise of further depreciation or of diminution of gain actually realized on a sale. Nor is it unreasonable for Congress to refuse to differentiate between two taxpayers depending upon whether tax benefits resulted from the deductions. Both taxpayers have been allowed the deductions and should not be entitled to it again. Neither taxpayer is being taxed on capital where the basis for measuring gain excludes amounts previously taken as a deduction.

In requesting reconsideration of the *Virginian Hotel* decision, moreover, the taxpayer does not offer any new evidence of Congressional intent which was overlooked in that case and which would show that the Court was wrong in its interpretation of the statute. Indeed, it is of some significance that, although Congress enacted rules regarding certain of the so-called tax benefit situations, no changes were made in Section 113 (b) (1) (B) of the Internal Revenue Code. See Section 116 of the Revenue Act of 1942, c. 619, 56 Stat. 798.

2. In determining the amount of gain sustained by the taxpayer on the sale of a partial interest in certain oil leases (the taxpayer having retained, by way of an oil payment, the right to a portion

of production until a certain amount was repaid), the courts below followed *Columbia Oil & Gas Co.* v. *Commissioner*, 118 F. 2d 459 (C. C. A. 5th), and allocated only a portion of the leasehold basis to the interest sold and the remainder to the interest retained by the taxpayer. The taxpayer claims that the allocation should not have been made and that it must recoup its entire leasehold investment before there is any gain taxable under the Constitution (Pet. 11–12). *Burnet* v. *Logan*, 283 U. S. 404, relied on by the taxpayer (Pet. 11), in which the complete property interest was sold but only a partial payment was received at the time of the sale, has no application where, as here, only a partial interest was sold (*Thomas* v. *Perkins*, 301 U. S. 655; *Palmer* v. *Bender*, 287 U. S. 551; *Anderson* v. *Helvering*, 310 U. S. 404, 410–413), and complete payment therefor was made at the time of the transfer. Where a taxpayer sells only a portion of a divisible property interest which he owns, there is no requirement that his investment in the whole property be returned tax-free, or that the taxation of gain be postponed until a profit is realized on the interest retained. See *Heiner* v. *Mellon*, 304 U. S. 271, and the cases cited at 275–276, notes 3 and 4.

3. In consideration of the receipt of property having a value in excess of $1,400,000, the taxpayer contracted to pay two annuities which could have been purchased from a reputable life insur-

ance company at a total cost of $350,287 (R. 34–35). The taxpayer claims (Pet. 12) that it should be entitled to deduct, under Section 23 (b), as interest paid, the portion of the annuity payments which is taxed to the annuitant under Section 22 (b) (2).

The asserted conflict between the decision below and *New England Mut. Life Ins. Co.* v. *Welch*, 153 F. 2d 260 (C. C. A. 1st), does not exist. In that case, payment of the face amount of policies of insurance, otherwise due in a lump sum, could be postponed at the election of a beneficiary or an insured so that payment would be made over a period of time, the postponed amount bearing interest at the rate of three percent compounded annually. It was held that the stipulated element of interest was deductible by the company as interest paid on an indebtedness since this amount constituted extra compensation paid by the company for the use of borrowed money during the agreed term of the loan. In the present case, however, there was no loan or borrowing. *Old Colony R. Co.* v. *Commissioner*, 284 U. S. 552; *Deputy* v. *duPont*, 308 U. S. 488. Here the taxpayer's only obligation was to pay the annual installments when due; if the annuitant died before receiving back the price which was paid for the annuity, the taxpayer was relieved of further obligation. The concept of interest as "compensation for the use or forbearance of money" where

there is an indebtedness has no application to the present circumstances. See also *Deputy* v. *du-Pont, supra,* at p. 498; *Old Colony R. Co.* v. *Commissioner, supra.* Moreover, even if interest had been paid, there is no showing respecting the precise amount of the deduction to which the taxpayer would be entitled and it must be denied on that ground as well. *Interstate Transit Lines* v. *Commissioner,* 319 U. S. 590. The decision below follows the decisions of other circuit courts of appeals and is clearly correct. *Autenreith* v. *Commissioner,* 115 F. 2d 856 (C. C. A. 3d); *Klein* v. *Commissioner,* 84 F. 2d 310 (C. C. A. 7th).

4. Certain issues which were raised by the taxpayer were decided, in part, in its favor by the Tax Court (R. 29, 34, 37–39). This resulted in altering the net income of the taxpayer from certain oil properties for the taxable years 1937 and 1939, and in changing its cost basis for certain oil interests. On recomputation of the tax deficiencies, the Tax Court, in order to give effect to its entire decision, recomputed the depletion allowance in accordance with the statutory provisions that the allowance, on a percentage basis, be 27½ percent of the gross income but not to exceed 50 percent of the net income from the property. Section 114 (b) (3) of the Internal Revenue Code and of the Revenue Act of 1936 (Appendix, *infra,* pp. 19–20). Where depletion was on a cost basis, it was computed in accordance with the basis as

determined in the decisions (R. 45, 281). It is thus clear, contrary to taxpayer's contention (Pet. 13), that no new issues were being raised on recomputation. Instead, the Tax Court was merely giving effect to the issues which were raised by the taxpayer and determined in its favor. This the Tax Court was required to do in deciding the issues before it and in determining the correct amount of the deficiency to be entered as the decision. See Rule 50, Rules of Practice Before the Tax Court (Revised to August 1, 1946) and Section 272 of the Internal Revenue Code.

CONCLUSION

The decision below is correct in all respects. There are no conflicts in decisions, and no substantial constitutional issue is presented for decision. Accordingly, the petition for writs of certiorari should be denied.

Respectfully submitted.

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NOVEMBER, 1946.

APPENDIX

REVENUE ACT OF 1936, c. 690, 49 Stat. 1648:

SEC. 22. GROSS INCOME.

* * * * *

(b) *Exclusions From Gross Income.*—The following items shall not be included in grass income and shall be exempt from taxation under this title:

* * * * *

(2) *Annuities, Etc.*—* * * Amounts received as an annuity under an annuity or endowment contract shall be included in gross income; except that there shall be excluded from gross income the excess of the amount received in the taxable year over an amount equal to 3 per centum of the aggregate premiums or consideration paid for such annuity (whether or not paid during such year), until the aggregate amount excluded from gross income under this title or prior income tax laws in respect of such annuity equals the aggregate premiums or consideration paid for such annuity. * * *

* * * * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or

continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this title.

* * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * *

(n) *Basis for Depreciation and Depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

* * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; * * *

* * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General Rule.*—Proper adjustment in respect of the property shall in all cases be made—

(A) for expenditures, receipts, losses, or other items, properly chargeable to capital account, including taxes and other carrying charges on unimproved and unproductive real property, but no such adjustment shall be made for taxes or other carrying charges for which deductions have been taken by the taxpayer in determining net income for the taxable year or prior taxable years;

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. Where for any taxable year prior to the taxable year 1932 the depletion allowance was based on discovery value or a percentage of income, then the adjustment for depletion for such year shall be based on the depletion which would have been allowable for such year if computed without reference to discovery value or a percentage of income;

* * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis for Depletion.*—

(1) *General Rule.*—The basis upon which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale

or other disposition of such property, except as provided in paragraphs (2), (3), and (4) of this subsection.

* * * * *

(3) *Percentage Depletion For Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would if computed without reference to this paragraph.

* * * * *

The corresponding provisions of the Internal Revenue Code are identical.

TREASURY REGULATIONS 94, promulgated under the Revenue Act of 1936:

Art. 113 (b)–1. *Adjusted basis: General Rule.*—* * *

* * * * *

The cost or other basis must also be decreased by the amount of the deductions for exhaustion, wear and tear, obsolescense, amortization, and depletion to the extent such deductions have in respect of any period since February 28, 1913, been allowed (but such decrease shall not be less

than the amount of deductions allowable) under the Revenue Act of 1936 or prior income tax laws. The adjustment required for any taxable year or period is the amount allowed or the amount allowable for such year or period under the law applicable thereto, whichever is the greater amount. * * *

* * * * *

The provisions of Section 19.113 (b) (1)–1 Treasury Regulations 103, promulgated under the Internal Revenue Code, are substantially identical.

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